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## Corporate Criminal Liability in the 21st Century: A New Era

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# CORPORATE CRIMINAL LIABILITY IN THE 21ST CENTURY: A NEW ERA?

LANCE COLE\*

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# I. HISTORICAL OVERVIEW: EXPANDING THEORIES OF CORPORATE CRIMINAL LIABILITY

## A. Historical Background: The Beginning of the 20th Century

Although it seems almost unimaginable today, at the beginning of the 20th century the United States Supreme Court actually gave serious consideration to the issue of whether a corporation could be held criminally liable for the acts of its employees.<sup>1</sup> After recognizing that the old common law rule, reported in Blackstone's Commentaries, was that a corporation could not commit a crime, the Court went on to hold that corporations can be held criminally liable based on the acts of their agents.<sup>2</sup>

The Court's decision in the *New York Central* case opened the floodgates for a century of judicial decisions and legislative actions that transformed the legal rules of corporate criminal liability.<sup>3</sup>

## B. Mid-Century Cases: Dramatically Expanded Corporate Criminal Liability

By the middle of the 20th century corporations were being held criminally liable even for unauthorized actions by corporate employees and agents, so long as those actions in some way benefited the corporation.<sup>4</sup> All the courts required was some incidental benefit to the corporation; liability could be imposed on the corporation when agents were acting primarily to benefit themselves, at times resulting

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1. See *N.Y. Cent. & Hudson River R.R. Co. v. United States*, 212 U.S. 481, 494 (1909).

2. *Id.*

3. See, e.g., Gilbert Geis & Joseph F. C. DiMento, *Empirical Evidence and the Legal Doctrine of Corporate Criminal Liability*, 29 AM. J. CRIM. L. 341, 348 (2002) (discussing the *New York Central* decision and its role in the creation of a federal body of law on the subject of corporate criminal liability).

4. See *Standard Oil Co. v. United States*, 307 F.2d 120, 127 (5th Cir. 1962).

in a loss to the corporation.<sup>5</sup>

Many corporate executives are surprised to learn that a corporation can be held criminally liable even for unauthorized acts of agents and employees that are contrary to company policy or even contrary to specific instructions.<sup>6</sup> All that is required in such cases is that the agent or employee be acting within the scope of his or her authority.<sup>7</sup>

*C. Late 20th Century Cases: Aggressive and Creative Theories of Corporate Criminal Liability*

By the end of the 20th century, prosecutors were not content to apply established theories of criminal liability to corporations. They aggressively sought to develop new theories that would impose liability on corporations in situations where application of traditional theories would not support liability. An example is the “collective knowledge” theory by which the actions and knowledge of a number of employees is aggregated and imputed to the corporation to support criminal liability.<sup>8</sup>

Other examples of expanded corporate criminal liability embraced by the courts and by Congress include the public welfare doctrine of strict criminal liability for corporations that commit public welfare offenses<sup>9</sup> and the corporate sentencing provisions of the Federal Sentencing Guidelines for Organizations,<sup>10</sup> which took effect in 1991 (in section 905 of the Sarbanes-Oxley Act of 2002, Congress directed the United States Sentencing Commission to review and amend the Federal Sentencing Guidelines and related policy statements to implement the corporate compliance and accountability provisions of that Act).<sup>11</sup>

*D. The Turn of the New Century: Corporate Criminal Liability is the Rule, Not the Exception*

By the turn of the century, large-scale corporate prosecutions had become commonplace, but with a new twist—criminal prosecution

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5. See *Steere Tank Lines v. United States*, 330 F.2d 719, 722 (5th Cir. 1964).

6. See *United States v. Hilton Hotels Corp.*, 467 F.2d 1000, 1004 (9th Cir. 1972).

7. *Id.*

8. See, e.g., *United States v. Bank of New England*, 821 F.2d 844, 856 (1st Cir. 1987).

9. See, e.g., *United States v. White Fuel Corp.*, 498 F.2d 619 (1st Cir. 1974) (explaining imposition of strict criminal liability under the public welfare doctrine).

10. U.S. SENTENCING GUIDELINES MANUAL ch. 8, introductory cmt. (2002).

11. See discussion *infra* Part III.

could literally kill the business entity. Although the Arthur Andersen case may be the most recent and in some ways most dramatic example, the trend was well underway before the Andersen prosecution.<sup>12</sup> Drexel Burnham Lambert, Inc. failed to survive the Michael Milken-related prosecution in the 1980s, and many believe that E.F. Hutton's multi-count guilty plea in the check-kiting prosecution ultimately led to the demise of that firm.<sup>13</sup>

Clearly by the turn of the century the stakes could not be any higher in cases of corporate criminal liability—a criminal prosecution may literally be a life or death crisis for a company.

## II. THE OTHER SHOE FALLS: EXPANSIVE CORPORATE CRIMINAL LIABILITY IS COUPLED WITH COOPERATION, VOLUNTARY DISCLOSURE, AND SELF-REPORTING PROGRAMS

Although new theories of corporate criminal liability made it easier to prosecute corporations in the late twentieth century, federal prosecutors and regulatory authorities did not rely solely on those theories to police corporate criminal activity. As corporate internal investigations were increasingly used by defense counsel to assess and remedy corporate wrongdoing, prosecutors began asking companies that were subjects of criminal inquiries to turn over to the government the results of their internal investigations.<sup>14</sup> Companies that cooperated and took remedial action to prevent future criminal misconduct could hope that the government would exercise prosecutorial discretion and not proceed against the corporate entity, or allow the corporate entity to plead guilty to lesser offenses, and instead proceed primarily against the individual wrongdoers.<sup>15</sup>

An important side effect of this new trend toward cooperation and voluntary disclosure was pressure to waive attorney-client privilege and work product doctrine protection for all or parts of reports of internal investigations that were shared with prosecutors.

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12. See Lee Hockstader, *Andersen Hit With Maximum Penalty; Judge Fines Firm \$500,000, Puts It on Probation*, WASHINGTON POST, Oct. 17, 2002, at E01, available at 2002 WL 101068791.

13. *Id.*; see also Michael B. Metzger, *Corporate Criminal Liability for Defective Products: Policies, Problems, and Prospects*, 73 GEO. L.J. 1, 62–74 (1984) (discussing how criminal law has been increasingly used to achieve an acceptable level of corporate control).

14. See Memorandum from the Dep't of Justice, Eric H. Holder, Deputy Attorney General, to All Component Heads and U.S. Attorneys § 1, ¶ VI.A. (June 16, 1999), available at <http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html> (last visited Dec. 18, 2003) [hereinafter Holder Memorandum].

15. See *id.*

Not surprisingly, before agreeing to favorable treatment based upon an internal investigation and remedial action, prosecutors often insisted upon access to the interview notes and privileged reports of the counsel who conducted the internal investigation. That access often necessitates waiver of attorney-client privilege and work product doctrine protection.

A. *The Department of Justice's 1999 Memorandum on "Federal Prosecution of Business Organizations"*

By mid-1999 these practices had become sufficiently commonplace within the Department of Justice to be memorialized in an internal policy memorandum by then Deputy Attorney General Eric H. Holder, Jr. addressing *Federal Prosecution of Corporations*. The Holder Memorandum "provides guidance as to what factors should generally inform a prosecutor in making the decision whether to charge a corporation in a particular case."<sup>16</sup>

Part II of the Holder Memorandum identified eight specific factors that prosecutors should consider in making a charging decision in a corporate criminal case. The fourth factor is: "The corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, *including, if necessary, the waiver of the corporate attorney-client and work product privileges.*"<sup>17</sup> Part VI of the Holder Memorandum, entitled "Charging the Corporation: Cooperation and Voluntary Disclosure," reiterates that "[i]n gauging the extent of the corporation's cooperation, the prosecutor may consider the corporation's willingness . . . to waive the attorney-client and work product privileges."<sup>18</sup>

A footnote in the Holder Memorandum stated that the waiver sought by the government "should ordinarily be limited to the factual internal investigation and any contemporaneous advice given to the corporation concerning the conduct at issue."<sup>19</sup> The first part of this statement suggests – appropriately – that the focus of the cooperation policy should be obtaining facts that were collected during the corporation's internal investigation.

The second part of the statement, however, inappropriately suggests that the government generally has a legitimate need to compel a waiver for privileged communications of legal advice

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16. *Id.*

17. *Id.* ¶ II.A(4). (emphasis added).

18. *Id.* ¶ VI.A.

19. *Id.* at n.2.

relating to the conduct at issue. That is not the case. Prosecutors need access to attorney-client communications and opinion work-product only if the corporation is relying on the advice of counsel as a defense or if the government believes the crime-fraud exception is applicable. In both of those situations the government is entitled to obtain the privileged communications under recognized exceptions to the privilege, and compelling a blanket waiver by the corporation is unnecessary. Moreover, in both of those instances the applicability of an exception to the privilege would be decided by a neutral judge, not by a prosecutor whose objective is a successful criminal prosecution.

The same footnote in the Holder Memorandum goes on to state that “[e]xcept in unusual circumstances, prosecutors should not seek a waiver with respect to communications and work product related to advice concerning the government’s criminal investigation.”<sup>20</sup> This statement raises a significant issue of potential abuse of government power. Requiring a corporate client to waive privileges with respect to legal advice provided in connection with an ongoing criminal investigation and potential prosecution, as opposed to legal advice provided in connection with the past conduct that is the subject of the pending criminal investigation, is effectively to deny that client assistance of counsel in the pending proceeding.

Because of the breadth of the waiver doctrine, a corporate client that waives privileges for advice and opinion work-product provided in an ongoing investigation is likely to lose the benefits of a confidential attorney-client relationship for all litigation and regulatory proceedings arising out of or related to that investigation.

The Holder Memorandum does not describe what “unusual circumstances” might justify requiring a waiver that would in effect result in an across-the-board denial of counsel, and it is difficult to envision a circumstance in which it would be appropriate for the government to do so. In fact, the kind of circumstances that might justify interfering with an ongoing attorney-client relationship, such as misuse of counsel’s advice to obstruct an investigation or destroy evidence, would almost certainly be subject to the crime-fraud exception to the privilege. In those kinds of cases the government can overcome the privilege under existing law without compelling a waiver.

As the discussion above suggests, the Holder Memorandum suffers from two fundamental flaws. First, it inappropriately focuses on obtaining privilege waivers in all cases, rather than on obtaining

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20. *Id.*

relevant underlying factual information, which is what government investigators should be seeking in the typical case and which usually can be obtained without requiring a waiver of privilege.

Second, the Holder Memorandum threatens to intrude inappropriately into ongoing attorney-client relationships by suggesting that in some cases prosecutors should seek a waiver with respect to attorney-client communications and opinion work-product relating to current representation in the pending criminal investigation. Both of these flaws unnecessarily jeopardize the continued viability of the attorney-client privilege in corporate criminal cases, and both are inconsistent with the Supreme Court's treatment of the corporate privilege in the leading case on that issue.<sup>21</sup>

*B. The Department of Justice's January 2003 "Principles of Federal Prosecution of Business Organizations"*

In 2003, the Bush Justice Department revised the Holder Memorandum. On January 20, 2003, Deputy Attorney General Larry Thompson distributed a new memorandum on "Principles of Federal Prosecution of Business Organizations."<sup>22</sup>

The Thompson Memorandum did not modify the waiver of privilege and work product protection position of the Holder Memorandum. The privilege waiver language of the Holder Memorandum is carried over without substantive change. Thus the Thompson Memorandum presumably reflects a policy decision by the Justice Department to continue to aggressively pursue privilege waivers. (This position is in notable contrast to the more carefully articulated position of the Securities and Exchange Commission in its official cooperation policy, discussed below.)

In another area, however, the Thompson Memorandum markedly increases the pressure on corporations to cooperate with criminal investigations and forego any effort to defend against criminal charges. A new penultimate paragraph in Part VI(B) of the Memorandum provides as follows:

Another factor to be weighed by the prosecutor is whether

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21. See *Upjohn Co. v. United States*, 449 U.S. 383, 392 (1981) (recognizing the importance of corporations receiving fully informed legal advice on how to comply with the law).

22. Memorandum from the Dep't of Justice, Larry D. Thompson, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Jan. 20, 2003), available at [www.usdoj.gov/dag/cftf/corporate\\_guidelines.htm](http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm) (last visited Jan. 5, 2004) [hereinafter Thompson Memorandum].



the corporation, while purporting to cooperate, has engaged in conduct that impedes the investigation (whether or not rising to the level of criminal obstruction). Examples of such conduct include: overly broad assertions of corporate representation of employees or former employees, inappropriate directions to employees or their counsel, such as directions not to cooperate openly and fully with the investigation including, for example, the direction to decline to be interviewed; making presentations or submissions that contain misleading assertions or omissions; incomplete or delayed production of records; and failure to promptly disclose illegal conduct known to the corporation.<sup>23</sup>

This new guideline obviously increases the leverage the Justice Department has over corporations and their counsel who are responding to a criminal probe. For example, it may be difficult to predict what prosecutors will consider “overly broad” assertions of corporate representation of employees or what constitutes “inappropriate” directions to employees or their counsel. Most companies and lawyers may hesitate to take any of the actions, such as seeking to control access to witnesses and documentary information, that in the past have routinely been employed to defend corporations against criminal charges. (Of course, there can be no assurance that even if a company cooperates fully with the government it will receive lenient treatment from the government, as the Arthur Andersen case illustrates so dramatically.)<sup>24</sup>

Taken together with the waiver provisions, the new “cooperation” requirements in the Thompson Memorandum go quite far toward effectively forcing a corporation to forgo any efforts to defend against a criminal investigation if it hopes to ultimately obtain favorable charging treatment at the hands of DOJ prosecutors. In complex corporate criminal cases federal prosecutors have enormous prosecutorial discretion to decide the nature and the number of charges, if any, that they will bring against the responsible corporate entity and culpable individuals. For that reason, the new, more demanding cooperation policy set out in the Thompson Memorandum is likely to have a significant impact on corporate behavior, perhaps even fundamentally changing the manner in which corporations respond to federal criminal investigations.

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23. *Id.* ¶ VI.B.

24. *See* Hockstader, *supra* note 12.

### C. The Securities and Exchange Commission's Cooperation Policy

The approach taken by the Department of Justice in the Thompson Memorandum and its predecessor, the Holder Memorandum, is not entirely consistent with the approach taken by the other federal law enforcement agency with the greatest influence on corporate behavior – the Securities and Exchange Commission.

In 2001 the Securities and Exchange Commission adopted a formal agency policy of granting leniency in exchange for cooperation in appropriate cases.<sup>25</sup> The SEC announced its new policy in connection with an October 2001 enforcement proceeding.<sup>26</sup> In *Gisela de Leon-Meredith*, the Commission took action against an individual corporate official for misstating her employer's financial results, but did not take any action against the corporate entities whose financial results had been misstated.<sup>27</sup>

The lack of enforcement action against the corporate parent was particularly noteworthy because the company was publicly traded and its financial statements had been misstated for five years in amounts that were significant in relation to previously reported earnings.<sup>28</sup> In such circumstances, a reporting company normally would do well to avoid fraud charges by the SEC and be "let off" with financial reporting and record keeping charges, but for the corporate entity not to be charged at all was a significant act of leniency on the part of the Commission and a notable departure from usual practice at the agency.

Apparently recognizing the significance of its action (or, more accurately stated, inaction) in not bringing an enforcement action against the corporate issuer, the SEC took the unusual step of explaining itself in a separate "Report of Investigation" that described the reasons for its leniency toward the issuer in the *Gisela de Leon-Meredith* case.<sup>29</sup>

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25. Report of Investigation Pursuant to Section 21(A) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969 (Oct. 23, 2001), available at 2001 WL 1301408 [hereinafter SEC Report].

26. *In re Gisela de Leon-Meredith*, Exchange Act Release No. 44,970 (Oct. 23, 2001), available at 2001 WL 1268303.

27. *Id.* at \*3.

28. *Id.* at \*2.

29. See SEC Report, *supra* note 25.

### 1. Measures of Cooperation

In its press release announcing the report, the SEC identified “four broad measures of a company’s cooperation”<sup>30</sup> that may influence the agency’s decision as to what enforcement action, if any, should be brought against the company.

The four measures are:

*Self-policing* prior to the discovery of the misconduct, including establishing effective compliance procedures and an appropriate tone at the top; *Self-reporting* of misconduct when it is discovered, including conducting a thorough review of the nature, extent, origins and consequences of the misconduct, and promptly, completely, and effectively disclosing the misconduct to the public, to regulators, and to self-regulators; *Remediation*, including dismissing or appropriately disciplining wrongdoers, modifying and improving internal controls and procedures to prevent recurrence of the misconduct, and appropriately compensating those adversely affected; [and] *Cooperation with law enforcement authorities*, including providing the Commission staff with all information relevant to the underlying violations and the company’s remedial efforts.<sup>31</sup>

These measures of cooperation are unremarkable, and are generally consistent with the policies of other agencies and the cooperation provisions of the Federal Organizational Sentencing Guidelines. The manner in which the application of these factors was described in the accompanying SEC Report, however, is somewhat troubling, particularly if the reader is not extremely attentive to the details of the Commission’s Report. The troubling aspect of the SEC Report is that on its first page, in the second key paragraph describing the SEC’s reasons for not taking action against the parent company in the *Gisela de Leon-Meredith* case, it emphasizes that “[a]mong other things, the company produced the details of its internal investigation, including notes and transcripts of interviews of Meredith and others; *and it did not invoke the attorney-client privilege, work product protection or other privileges or protections with respect to any facts uncovered in the investigation.*”<sup>32</sup>

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30. Press Release, SEC, SEC Issues Report of Investigation and Statement Setting Forth Framework for Evaluating Cooperation in Exercising Prosecutorial Discretion, SEC Press Release No. 2001-117 (Oct. 23, 2001).

31. *Id.*

32. SEC Report, *supra* note 25, at \*1 (emphasis added).

## 2. Attorney-Client Privilege Issues

This language about privilege, and the prominence it was given in what was clearly intended to be a major policy statement by the federal agency with principal responsibility for policing the financial markets and regulating corporate America, is unfortunate because it tends to distort an important nuance in what is otherwise a very carefully considered and well-crafted policy statement by the SEC.

The privilege language quoted above could easily be read to suggest that waiving privileges is necessary in order to obtain credit for cooperation. That interpretation is incorrect, however, because a close reading of the entire SEC Report makes clear that waiver of privileges, as such, is neither an objective of the SEC nor a condition for receiving full credit for cooperating with the agency.

Near the end of the SEC Report the Commission provides a non-exclusive list of thirteen criteria that it may consider in determining whether to give the subject of an enforcement action credit for cooperation.<sup>33</sup> The eleventh listed criterion identifies the relevant issues with respect to assertion of attorney-client privilege and work product doctrine protection:

11. Did the company promptly make available to our staff the results of its review and provide sufficient documentation reflecting its response to the situation? Did the company identify possible violative conduct and evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law? Did the company produce a thorough and probing written report detailing the findings of its review? Did the company voluntarily disclose information our staff did not directly request and otherwise might not have uncovered? Did the company ask its employees to cooperate with our staff and make all reasonable efforts to secure such cooperation?<sup>34</sup>

Unlike the gratuitous reference to not invoking privileges found on the first page of the SEC Report, this language neither emphasizes waiving privileges nor implies that doing so is necessary to obtain credit for cooperation. Instead, the language appropriately focuses on voluntary disclosure of all relevant underlying factual information, including information that might not otherwise be discovered by government investigators, and cooperation by the corporate entities involved, such as by encouraging employees to cooperate with the investigation. Moreover, the omission of any references to waiving

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33. *Id.* at \*2-\*4.

34. *Id.* at \*3.

privileges in this criterion clearly is both a considered and intentional decision by the agency, as an accompanying footnote explains.<sup>35</sup>

In the footnote on privileges, the SEC Report takes a more measured approach to addressing the relationship between corporate cooperation and privilege protections than the broad waiver policy of the Department of Justice, discussed above. The SEC footnote stresses the Commission's recognition that the attorney-client privilege and the work product doctrine, as well as other privileges, "serve important social interests."<sup>36</sup> The footnote goes on to state explicitly that "the Commission *does not view a company's waiver of a privilege as an end in itself*, but only as a means (where necessary) to provide relevant and sometimes critical information to the Commission staff."<sup>37</sup>

The Commission has taken the position in litigation that "the provision of privileged information to the Commission staff pursuant to a confidentiality agreement [does] not necessarily waive the privilege as to third parties."<sup>38</sup> This language reinforces the point, discussed below, that the SEC did not intend to suggest that waiving privileges is necessary to obtain credit for cooperation. In fact, it appears that the Commission would not regard providing even privileged information (as opposed to underlying factual information) as necessarily constituting a waiver.

The SEC took the right approach. As the discussion in the footnote implicitly recognizes, it is possible, and even probable in most cases, for a party under investigation to cooperate fully with the government and provide investigators with all relevant underlying factual information without waiving privileges. Nothing in the SEC's carefully articulated analysis of the privilege issue suggests hostility to the privilege or implies that waiver is necessary to obtain credit for cooperation. To the contrary, the discussion not only demonstrates sensitivity to the importance of the compelled privilege waiver issue, but also a willingness to work with parties to avoid unnecessary waivers that might undermine the continued vitality of the privilege.

The Commission's solicitous approach to the privilege and its desire to avoid unnecessary waiver is further evidenced, although very subtly, by the carefully chosen wording that is used in both the text and privilege footnote. The text states that the company under

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35. See *id.* at n.3.

36. *Id.*

37. *Id.* (emphasis added).

38. *Id.*

investigation “did not invoke” the privilege, while the footnote states that companies under investigation by the SEC may “consider choosing not to assert” the privilege.<sup>39</sup> The Commission’s use of this very precise language, rather than referring to “waiver” or “waiving” the privilege, is consistent with the overall conclusion that the SEC did not intend to require wholesale waivers of privilege by companies under investigation in order to obtain the benefits of the new cooperation policy. In fact, the footnote discussion indicates that, in at least one litigated case,<sup>40</sup> the SEC has taken the position that voluntarily providing information to the SEC pursuant to a confidentiality agreement should not operate as a waiver as to third parties.<sup>41</sup> In addition, there is a recent decision by an influential court holding that providing information to law enforcement agencies pursuant to a confidentiality agreement does not constitute a waiver.<sup>42</sup>

This is an important point that should be noted both by companies that are under investigation by the SEC and by other federal law enforcement authorities that are developing or applying cooperation policies. In most cases, it will not be necessary or appropriate for law enforcement officials to require waiver of privileges by parties under investigation. If the investigating authorities do require such waivers, they risk undermining the important public policy interests that underlie the attorney-client privilege and the work product doctrine.

*D. Other Federal Government Cooperation, Voluntary Disclosure, and Self-Reporting Programs*

As the Thompson Memorandum notes, a number of government agencies, such as the Environmental Protection Agency and the Department of Justice Antitrust Division, have “formal voluntary disclosure programs in which self-reporting, coupled with remediation and additional criteria, may qualify the corporation for amnesty or reduced sanctions.”<sup>43</sup> Counsel representing a business entity, and particularly those whose business activities are subject to regulatory oversight, must determine whether a regulatory agency’s voluntary

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39. *Id.* at \*1, n.3.

40. *Id.* at n.3 (citing, Brief of Amicus Curiae SEC, McKesson HBOC, Inc. (Ga. Ct. App. May 13, 2001) (No. 99-C-7980-3)).

41. *Id.*

42. See *Saito v. McKesson HBOC, Inc.*, No. Civ. A. 18553, 2002 WL 31657622, at \*6–\*12 (Del. Ch. Oct. 25, 2002) (unpublished opinion).

43. Thompson Memorandum, *supra* note 22, ¶ VI.B.

disclosure policy applies to a given fact situation. An example is the health care field, where the Department of Health and Human Services has implemented a "Provider Self-Disclosure Protocol" that provides for mitigation of penalties in exchange for voluntary disclosure and cooperation with the Department's Office of Inspector General.<sup>44</sup>

### III. CONGRESS RAISES THE STAKES EVEN HIGHER: THE SARBANES-OXLEY ACT OF 2002

On July 30, 2002, President Bush signed into law new accounting reform and securities law/corporate governance legislation, the Sarbanes-Oxley Act of 2002.<sup>45</sup> Among other things, the Act provides for the creation of a new public accounting oversight board, imposes new reporting and corporate governance rules on public companies, imposes new rules and requirements on accounting firms that audit public companies, and establishes new criminal penalties for securities fraud, destruction of documents, and knowingly filing false certifications of the accuracy of periodic reports that contain financial statements.<sup>46</sup>

The discussion that follows focuses on what may well be the most controversial provision of the Sarbanes-Oxley Act, which is also the provision that without question is most relevant to the role of counsel in responding to evidence of criminal misconduct in the corporate context. Section 307 of the Act provides as follows:

Not later than 180 days after the enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission *in any way* in the representation of *issuers*, including a rule –

(1) requiring an attorney to report evidence of a *material* violation of securities law or breach of *fiduciary duty or similar violation* by the company or *any agent* thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel or officer does not *appropriately* respond to the evidence (adopting, as necessary, *appropriate remedial measures or sanctions* with respect to the violation), requiring

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44. See Provider Self-Disclosure Protocol, 63 Fed. Reg. 58,399 (Oct. 30, 1998).

45. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

46. *Id.*

the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.<sup>47</sup>

*A. Effect of Section 307 on the Attorney-Client Corporate Relationship*

As the italicized language above suggests, this section of the Act raises a number of significant statutory interpretation issues that the SEC is seeking to address through adopting and interpretative releases, discussed below, many of which may eventually have to be resolved by the courts. Beyond these interpretation issues, however, the Act has the potential to alter significantly the relationship between public companies and their attorneys. On its face, section 307 appears to go quite far toward changing the role of corporate attorneys from confidential advisors to public watchdogs and whistleblowers. The effect of the new law may be to blur the distinction between independent public accountants who have traditionally played the public watchdog role,<sup>48</sup> and outside counsel who have enjoyed a confidential relationship with their corporate clients<sup>49</sup>

In *Upjohn* the Supreme Court confirmed that the attorney-client privilege and the work-product doctrine protect communications between corporate counsel and the corporation's employees, so long as the purpose of the communications is to provide legal advice to the corporation and prepare for potential litigation.<sup>50</sup> By extending the availability of the attorney-client privilege beyond a corporation's "control group" and by extending work-product protection to interviews of lower level employees by corporate counsel, the *Upjohn* Court recognized the importance of employees at all levels communicating with corporate counsel and obtaining advice on compliance with the law.<sup>51</sup>

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47. *Id.* (codified as 15 U.S.C. § 7245 (2002)) (emphasis added).

48. *See United States v. Arthur Young & Co.*, 465 U.S. 805, 808–12 (1984).

49. *See Upjohn Co. v. United States*, 449 U.S. 383, 389–90 (1981).

50. *Id.* at 390.

51. *See id.* at 392; *see also* Sherman L. Cohn, *The Organizational Client: Attorney-Client Privilege and the No-Contact Rule*, 10 GEO. J. LEGAL ETHICS 739, 754 (1997) ("The Court's opinion clearly supports the idea that corporations need privacy to the extent afforded by the attorney-client privilege to comply with laws, and that internal investigations should be protected as a corporate effort to monitor compliance.") (citing



The *Upjohn* Court was also concerned that without the confidentiality protections of the attorney-client privilege and the work-product doctrine, the depth and quality of investigations to ensure compliance would suffer and employees might be deterred from seeking advice on how to comply with the law.<sup>52</sup>

Ironically, the outcome that the Supreme Court sought to avoid in *Upjohn* in 1981 appears to be promoted, albeit indirectly, by the attorney reporting requirements in § 307 of the Sarbanes-Oxley Act. The attorney-client privilege and work-product doctrine protections that the Court endorsed for corporations and other business entities in *Upjohn* are undercut if attorneys representing the corporation are viewed by corporate employees and officials as potential whistleblowers rather than as trusted confidential advisers. In this regard, § 307 seems likely to exacerbate the inherent tensions that are present when an attorney represents a business entity that can act only through individual officers and employees, who as individuals are not the clients of that attorney.

### *B. SEC Rulemaking Activity to Date*

In late 2002 the Securities and Exchange Commission proposed implementing rules that went beyond the “up the [corporate] ladder” reporting requirement in the text of Sarbanes-Oxley Act section 307, set forth above.<sup>53</sup>

#### *1. The SEC’s Original Proposal*

The initial SEC rule proposal included a “reporting out” requirement for counsel who do not receive an “appropriate response” to their internal reporting of a violation. Under the initial SEC proposal, outside counsel who do not receive an appropriate response from the company are required to effect a so-called “noisy withdrawal” by withdrawing from the representation and disaffirming any submissions to the Commission that they have participated in preparing that are tainted by the violation.<sup>54</sup> In-house attorneys are not required to resign, but are required to disaffirm any tainted

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*Upjohn*, 449 U.S. at 394–95).

52. See *Upjohn*, 449 U.S. at 393 n.2.

53. See Implementation of Standards of Professional Conduct for Attorneys, Securities Act of 1933 Release Nos. 33-8150, 34-46868, SEC Docket (CCH) (Dec. 18, 2002), ¶ IV.A.

54. See *id.* ¶¶ IV.A–B.

submission they have participated in preparing.<sup>55</sup> In addition, the initial proposed rule provided that an attorney who reasonably believes that he or she has been discharged by a company for fulfilling the reporting obligations imposed by the rule may, but is not required to, notify the Commission and disaffirm in writing any submission to the Commission that he or she participated in preparing which is tainted by the violation.<sup>56</sup>

## 2. *The SEC's "Up-the-Ladder" Attorney Reporting Rule*

On January 24, 2003, the SEC announced it was approving a "reporting up" rule, but was extending the comment period on the "noisy withdrawal" provisions of the original proposed rule.<sup>57</sup> The SEC approved the publication for comment of an alternative proposal:<sup>58</sup>

The Commission voted to extend for 60 days the comment period on the "noisy withdrawal" and related provisions originally included in proposed Part 205. Given the significance and complexity of the issues involved, including the implications of a reporting out requirement on the relationship between issuers and their counsel, the Commission decided to continue to seek comment and give thoughtful consideration to these issues.

The Commission also voted to propose an alternative to "noisy withdrawal" that would require attorney withdrawal, but would require an issuer, rather than an attorney, to publicly disclose the attorney's withdrawal or written notice that the attorney did not receive an appropriate response to a report of a material violation.<sup>59</sup>

The final "up-the-ladder" reporting rule adopted by the SEC seeks to clarify the interpretative issues arising under the language of § 307 and prescribes a detailed set of procedures to be followed by counsel.<sup>60</sup>

On the important issue of what evidence is sufficient to trigger

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55. *Id.* ¶ IV.B.

56. *Id.*

57. Press Release, SEC, SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act, SEC Press Release 2003-13 (Jan. 23, 2003), available at <http://www.sec.gov/news/press/2003-13.htm> (last visited Dec. 18, 2003).

58. *Id.*

59. *Id.*

60. See Standards of Prof'l Conduct for Attorneys, 17 C.F.R. § 205 (2003), available at <http://www.sec.gov/rules/final/33-8185.htm>. (last visited Dec. 18, 2003) [hereinafter Final Rule Release].

an attorney's reporting obligation, the new rule provides that "[e]vidence of a material violation means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."<sup>61</sup> The Final Rule Release explains that this language is intended to impose an "objective standard" for reporting and that an attorney is not expected to report gossip, hearsay, or innuendo.<sup>62</sup>

Another noteworthy aspect of the final up-the-ladder reporting rule adopted by the Commission is that it abandoned a requirement in the rule originally proposed by the Commission that a reporting attorney document the report and the response thereto. In abandoning the documentation requirement, the Commission acknowledged that the comments it received on the proposed rule were almost unanimously in opposition to the documentation requirement, and that those comments raised legitimate concerns that a documentation requirement has the potential to create a conflict of interest between the lawyer and his or her client.<sup>63</sup> For those reasons, the final rule does not include any affirmative documentation requirement.

The final rule includes detailed provisions on when an attorney is "appearing and practicing before the Commission" (and therefore subject to the rule), the procedures that must be followed in reporting up-the-ladder, and the actions that an attorney must take if he or she does not receive "an appropriate response" after reporting evidence of a material violation.<sup>64</sup> Those provisions merit careful attention and study by all attorneys, as the definition of "appearing and practicing" before the Commission is broad and the rule's application therefore will be widespread.

As important as those technical provisions are, for purposes of this discussion the most important aspect of the final rule as adopted in January 2003 is that it does not include any mandatory "noisy withdrawal" or "reporting out" requirements. The final rule does, however, provide that an attorney "may reveal to the Commission, without the issuer's consent, confidential information related to the representation" in certain circumstances.<sup>65</sup> Those circumstances include (i) preventing the issuer from causing substantial injury to the

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61. *Id.* § 205.2.

62. Press Release, SEC, *supra* note 57.

63. *Id.*

64. *Id.*; 17 C.F.R. § 205.4–205.5.

65. 17 C.F.R. § 205.3(d)(2) (emphasis added).

financial interest of the issuer or investors, (ii) preventing the issuer from committing or suborning perjury or perpetrating a fraud on the Commission, and (iii) rectifying the consequences of a material violation by the issuer that caused substantial injury to the financial interest of the issuer or investors in the furtherance of which the attorney's services were used.<sup>66</sup>

### 3. *The SEC's New Proposal on "Reporting Out" By Attorneys*

Although these non-mandatory "reporting out" provisions of the new rule are likely to be controversial, their import may be eclipsed by other actions yet to be taken by the Commission on the "reporting out" issue. In a separate release issued on the same day as the Final Rule Release, the Commission extended comment on its initial noisy withdrawal proposal and also proposed an alternative approach to reporting out.<sup>67</sup>

In the Proposed Reporting Out Rule Release, the Commission acknowledged the firestorm of criticism its initial noisy withdrawal reporting out proposal had provoked.<sup>68</sup> In response to those comments, the Commission proposed new alternative provisions that prescribe attorney withdrawal in a narrower set of circumstances and require the issuer (that is, the client) rather than the attorney to report the attorney's withdrawal to the Commission.<sup>69</sup>

The proposed alternative rule requires an attorney who does not receive an appropriate response to his or her up-the-ladder reporting of a material violation to withdraw from the representation if he or she "reasonably *concludes* that there is *substantial* evidence of a material violation that is ongoing or about to occur and is likely to cause substantial injury to the financial interest or property of the issuer or of investors."<sup>70</sup> The original proposal required withdrawal when there was a "reasonable belief," as opposed to "substantial evidence," of such circumstances. The Commission has solicited comment on "whether requiring a different and higher evidentiary standard for withdrawal than for reporting up-the-ladder of the issuer, such as requiring an attorney to 'conclude' there is 'substantial evidence,' will make the circumstances in which an attorney must

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66. *Id.*

67. See Implementation of Standards of Prof'l Conduct for Attorneys, 68 Fed. Reg. 6324, 6324 (Feb. 6, 2003) (codified at 17 C.F.R. pts. 205, 240, 249) [hereinafter Proposed Purporting Out Rule Release].

68. See *id.* at 6325.

69. See *id.*

70. *Id.* at 6335 (emphasis added).

withdraw (triggering an issuer's notification of the Commission) too narrow to adequately protect investors."<sup>71</sup>

The other substantial change in the SEC's new proposed reporting out rule is that the issuer, rather than the attorney, is required to report the attorney's withdrawal to the SEC. The new proposal provides that when an attorney provides an issuer with a written notice of withdrawal, based upon the attorney having not received an adequate response to his or her up-the-ladder reporting, then the issuer must within two days report the withdrawal to the SEC by filing a Form 8-K with the Commission. If the issuer fails to comply with this reporting requirement, the withdrawing attorney may, but is not required to, inform the SEC of the withdrawal.<sup>72</sup>

Two things about this proposed alternative reporting out procedure should be noted. First, the issuer's report on Form 8-K that the SEC is proposing is similar to the reporting required for a change in a company's independent accountant under existing SEC rules.<sup>73</sup> By treating attorney withdrawal in a manner similar to changes in independent auditors, the Commission will blur the line between independent auditors, who play a public watchdog role and are in a quasi-adversarial relationship with their clients, and corporate counsel, who up until now have been advocates and advisers, and have had a confidential relationship with their clients.<sup>74</sup> Blurring this previously clear distinction could fundamentally alter the nature of the relationship between corporations and their attorneys, arguably in a way that is contrary to the guidance the Supreme Court has provided on this important legal issue.

Second, and perhaps even more important, the alternative procedure proposed by the SEC, in which the client rather than the lawyer reports the withdrawal to the SEC probably is a distinction without a real difference. In either case, the attorney's decision to withdraw will set in forth a chain of events that by law must culminate with notification of law enforcement officials.<sup>75</sup> Both procedures are likely to undermine significantly the relationship of trust and confidence between corporations and their counsel. Moreover, as

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71. *Id.* at 6328.

72. *See id.*

73. *See* SEC, Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, No. S7-22-02, 2002 WL 1315511, § 4 (June 17, 2002).

74. *See supra* Part III.A (discussing the *Arthur Young* and *Upjohn* Supreme Court cases).

75. Under either proposal it may be the attorney who reports to the Commission, as under the alternative proposed rule an attorney who wishes to do so may inform the Commission if his or her former client fails to report the withdrawal as required by law.

discussed below, both approaches are likely to undermine the attorney-client privilege in the corporate context.

### *C. Section 307 and Waiver of Privilege Protections*

Remarkably, in its original rule proposal, the SEC took the position that an attorney's notification to the Commission under the proposed rules does not breach the attorney-client privilege.<sup>76</sup> The SEC repeated that position in the Proposed Reporting Out Rule Release, but acknowledged that its alternative proposal requiring the issuer, rather than the attorney, to report out to the Commission was intended to address commenters' concerns "related to the attorney-client privilege."<sup>77</sup> The Commission's position on the attorney-client privilege waiver issue notwithstanding, courts and litigants will no doubt expend considerable energy grappling with this issue if either form of the "reporting out" rule is ultimately adopted by the SEC.

Although the privilege waiver issue presumably will remain unresolved until the SEC both formulates a final rule and the rule is tested in the courts, two points should be noted. First, it is noteworthy that the text of the statute, quoted above, imposes only internal reporting requirements, for which compliance does not raise attorney-client privilege issues, while both the SEC's initial proposed rule and the alternative proposal rule announced on January 23, 2003, go beyond the statute and impose external reporting requirements that raise serious attorney-client privilege issues. The SEC presumably reads the "including a rule" language in § 307, set out above, as providing the agency with statutory authority to promulgate rules in addition to the "reporting up" through the corporate hierarchy rule that is specifically required by the Act. Even if the SEC reads the "including a rule" language this way, whether the SEC's proposed "noisy withdrawal reporting out" rule is a wise exercise of the agency's rulemaking authority is a separate question—particularly when one of the foundations of our adversarial legal system is at stake.<sup>78</sup>

Second, whether adopted in the initial proposed form or in the revised form announced by the SEC in the Proposed Reporting Out

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76. See Proposed Reporting Out Rule Release, *supra* note 67, at 6326.

77. See *id.* at 6329.

78. Cf. *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981) (stressing the importance of employees at all levels of a corporation communicating freely with corporate counsel so as to ensure that corporations receive informed advice on how to comply with the law).

Release, any “reporting out” requirement imposed by the SEC will clearly have a profound effect upon the relationship between attorneys and clients in the context of corporate representations. While it is impossible to predict the magnitude of that effect at this time, before final rules are adopted and subjected to judicial review, it is unlikely that such a rule could have a positive effect on the attorney-client privilege or the relationship between corporate clients and their counsel.

Whether or not the SEC adopts a reporting out rule to supplement the up-the-ladder reporting rules it has already adopted, § 307 of the Sarbanes-Oxley Act will increase the pressures on business entities to waive the protections of the attorney-client privilege and the work-product doctrine when evidence of misconduct subject to the § 307 reporting requirement is discovered.

The Justice Department’s “Thompson Memorandum” and the SEC’s new cooperation policy, discussed above, both require prompt self-reporting of violations of law if corporations wish to receive lenient treatment from the government. Of course, none of these policies provide any assurances of lenient treatment, so a company that seeks to obtain lenient treatment by self-reporting does so at its own risk – as illustrated by the DOJ’s decision to seek felony convictions of Arthur Andersen after that firm voluntarily reported destruction of documents relating to its work for Enron.<sup>79</sup>

For these reasons, when confronted with a § 307 report, a corporation may well conclude that it has no practical alternative but to report the matter to law enforcement authorities. When that occurs, outside attorneys who reported the matter under § 307 will have set in motion a chain of events that may result in a waiver of privilege and, in some cases, criminal prosecution of their client. It is difficult to reconcile this scenario with the approach that the Supreme Court took in *Upjohn*, when it stressed the importance of the attorney-client privilege in the corporate context to facilitate thorough internal investigation of potential wrongdoing and confidential counseling to foster future compliance with the law. It is also difficult to imagine how this scenario can do anything but undermine the

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79. See Kurt Eichenwald, *Arthur Andersen Convicted of Obstruction of Justice*, N.Y. TIMES, June 15, 2002, available at <http://www.nytimes.com> (“In early January, as lawyers for the firm were examining laptop computers for e-mail messages related to Enron, the were stunned to discover that the records had been wiped clean. In the days that followed, top executives of the accounting firm learned of the huge effort to destroy documents in the fall. Andersen alerted the S.E.C., the Justice Department and the Congressional committees investigating Enron.”).

relationship between corporate attorneys and their clients.

#### IV. CONCLUSION: CAN A BUSINESS ENTITY STILL CONTEST OR EVEN AGGRESSIVELY DEFEND AGAINST CRIMINAL CHARGES?

The new laws and law enforcement policies that are described above have altered the rules of the game for counsel defending white collar criminal cases involving corporations and securities law violations. Companies that do anything other than voluntarily self-report evidence of a possible crime and then cooperate fully with the government's investigation are proceeding at great peril. The rewards for cooperation, and the accompanying disadvantages of not cooperating, are now very substantial. To receive full credit for cooperation, companies may even have to waive privileges and assist the government in building criminal cases against present or former employees. Overall, the position of companies who are at risk of being charged with criminal conduct has been substantially weakened and the role of outside counsel significantly complicated by the need to assess the benefits of cooperating against the risks of aggressively defending against a criminal investigation.

On the other hand, none of the laws or law enforcement policies described above provides any absolute guarantees or assurances of lenient treatment by law enforcement authorities when a company self-reports and cooperates with the government (and as the Andersen case demonstrates, the consequences of voluntary disclosure may be catastrophic even when a company takes steps to self-report and cooperate).

Privilege waiver also is a significant risk if the company elects to cooperate, and counsel should devote careful attention to the waiver issue. While the government cooperation policies suggest that waiver of privilege is required in order to receive credit for cooperation, the policies do not explicitly require it in all cases. The better and more carefully articulated policies, such as the SEC's cooperation policy, suggest that in most cases cooperation sufficient to obtain lenient treatment should be possible without waiving privileges.

If counsel proceeds carefully, it may be possible to cooperate by providing government investigators with relevant factual information but not disclosing privileged attorney-client communications or work-product that reflects the opinions or legal theories of counsel. In some cases, such as those in which the government insists on broad privilege waivers, the best approach may still be to decline to cooperate and force the government to overcome the presumption of innocence by



proving its case with evidence developed through its own investigation. Such cases may now be the exception, rather than the rule, however, in what may be a new era of white-collar criminal practice.